HEALTH CARE DISTRIBUTORS

Research Brief

Sustainable Industry Classificaton System™ (SICS™) #HC0302

Research Briefing Prepared by the

Sustainability Accounting Standards Board®

August 2013

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SASB's industry brief provides a summary of the material sustainability issues that are likely to impact shareholder value. The issues identified within are industry specific, and reflect how the associated companies rely on environmental, social, and human capital. Further, the brief identifies material sustainability issues that pertain to business model and innovation, and governance. SASB adheres to the U.S. Supreme Court definition of materiality, defined as "presenting a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." To identify material sustainability issues, SASB's research team examines three types of evidence; evidence of interest, evidence of financial impact, and forward looking impact. The research reflected within this document was conducted by SASB and an initial version of the document served as an input for the Industry Working Groups to evaluate the materiality of industry issues and potential accounting metrics. The industry brief is not the disclosure standard, but rather is intended to provide background context and evidence for the material sustainability issues that SASB identified for the given industry. SASB takes sole responsibility for errors and omissions.

Related Documents

- Health Care Sustainability Accounting Standards
- Industry Working Group Participants
- SASB Conceptual Framework
- Example of Integrated Disclosure in Form 10-K

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MATERIAL SUSTAINABILITY ISSUES

Environmental Capital

- Fuel Efficiency

Social Capital

- Product Safety
- Counterfeit Drugs

Human Capital

Business Model and Innovation

- Product Lifecycle Management

Governance

- Corruption and Bribery

INDUSTRY SUMMARY

Health care distributors supply medical equipment and drugs to hospitals, pharmacies, and physicians.[1]

Health care distributors are driven by health care utilization. The expansion of health insurance under the Patient Protection and Affordable Care Act is expected to provide growth in the industry. In addition, the aging population in the U.S. will contribute to increased demand for pharmaceuticals, providing additional business for health care distributors. Increased participation in government insurance programs, electronic health records, and consolidation throughout the health care sector will likely continue to shape the industry, as emphasis is placed on reduced costs and improved efficiencies. In particular, growth in the demand for generic drugs will bring higher margins than branded drugs.

Health care distributors must respond to changes in both the legislative and regulatory environment. Recent trends suggest a further alignment between the interests of society and

[1] A list of the top five companies by revenue appears in Appendix I

those of long-term investors. These trends will also amplify how non-financial forms of capital contribute to market value. More specifically, the management of environmental, social, and human capital will increasingly affect traditional valuation by impacting revenue, assets, liabilities, and cost of capital. The ability of companies to manage these issues while also addressing the associated risks and opportunities through governance will be strong indicators of management quality and long-term value.

To ensure that shareholders are able to evaluate these factors, health care distributors should report on the material sustainability risks and opportunities that may affect value in the near and long term. Enhanced reporting will provide stakeholders with a more holistic (and comparable) view of performance that includes both positive and negative externalities, and the non-financial forms of capital that health care distributors rely on to create long-term value.

The sustainability issues that will drive competitiveness within health care distributors industry include:

- Improving the fuel efficiency of distribution networks and
- Ensuring product safety through proper handling and labeling
- Detecting counterfeit medications and preventing their entrance into the U.S. market
- Managing the lifecycle of products
- Addressing corruption and bribery and ensuring that business practices allow for innovation and access
- The extent to which these sustainability issues impact value will become increasingly apparent as the regulatory environment continues to evolve and emphasis is placed on increased access, greater efficiency, reduced costs, and improved patient outcomes.

The extent to which these sustainability factors impact value will become increasingly apparent as the legislative and regulatory environment for the health care sector continues to evolve, and emphasis is placed on increased access, greater efficiency, reduced costs, quality of products and services, preventative care, and improved patient outcomes.

LEGISLATIVE AND REGULATORY TRENDS IN HEALTH CARE DISTRIBUTORS

The regulatory environment that governs health care distributors continues to evolve. The following section provides a brief summary of key legislative efforts and associated industry trends that are likely to affect profitability.

The Patient Protection and Affordable Care Act (PPACA) is expected to benefit the industry by expanding health insurance to 26 million people who were previously uninsured.[i,2]

This will lead to increased access to health care services and drug utilization. The Act will also present challenges to segments of the industry as consolidation within the health care sector can increase the ability of payers and providers to negotiate lower prices.

The American Recovery and Reinvestment Act of 2009 included provisions for $1.1 billion dollars in funding for the advancement of comparative effectiveness research (CER). The framework is intended to provide health care providers with the necessary information to make value-based decisions. CER has the potential to shift the market toward generics or alternative therapies, impacting sales for companies in this industry. Increased utilization of generic drugs will create both challenges and opportunities for health care distributors – price and volume pressure on branded drugs and growth from distribution of higher margin generics.

SUSTAINABILITY RISKS AND OPPORTUNITIES

Recent trends in the regulatory environment suggest an effort to address product safety, improve patient outcomes, and reduce costs to consumers. Health care distributors will therefore not be able to maximize financial capital unless they address material sustainability issues as well. Firms that are able to negotiate new regulations, while addressing all forms of capital and limiting negative externalities will be better positioned to protect shareholder value in the long term.

The following section provides a brief description of how the health care distributors industry depends on each form of capital and the specific sustainability issues that will drive performance including: evidence of materiality, value impact, and timing. Tables indicating the type of evidence gathered to demonstrate materiality for each issue, and the recommended disclosure framework appear in Appendix II and III. An analysis of the current state of reporting on material sustainability issues in the health care distributors industry appears in Appendix IV.

ENVIRONMENTAL CAPITAL

Companies in this industry rely on vast distribution networks that depend on environmental capital. As resources become limited, and legislation seeks to address the associated externalities, investors must understand how individual health care distributors manage the potential for increased fuel costs through improved efficiency.

[2] Estimates range between 26 and 30 million for the number of people will become insured under the PPACA.

Fuel Efficiency

The distribution of health care products and supplies requires significant transportation networks. As concern over climate change and dwindling natural resources continues to impact fuel pricing, health care distributors will be exposed to fluctuations in costs. Firms that are able to improve transportation efficiencies are likely to enhance shareholder value.

Evidence

As energy prices continue to rise, fuel costs will become increasingly material. Distribution companies are therefore working to develop new strategies to improve efficiency, and protect shareholder value.

Cardinal Health reports that "Due to competitive dynamics and contractual limitations, we may be unable to pass along cost increases through higher prices. If we cannot fully offset cost increases through other cost reductions, or recover these costs through price increases or surcharges, our results of operations could be adversely affected."

Value Impact and Timing

Efforts to improve fuel efficiency reduce operating costs, and create positive shareholder value in both the near and long term.

SOCIAL CAPITAL

The health care distributors industry does not manufacture the products that it distributes. However, these companies are an essential part of the supply chain, and subsequently share in the responsibility for product safety and authenticity. Companies that are able to address these aspects of social capital will be better positioned to protect shareholder value.

Product Safety

Health care distributors play an integral role in the delivery of health care products to consumers. The industry therefore has a shared responsibility along with manufacturers to ensure safety, labeling, and quality. Health care distributors that limit that incidence of safety or other product claims will be better positioned to protect shareholder value.

Evidence

Cardinal Health has been investigated by the Drug Enforcement Agency (DEA) for concerns over painkiller distribution. In February, the DEA suspended Cardinal Health's license to ship controlled substances from its distribution facility in Lakeland, Florida, alleging that the company had endangered public health in part by selling enough oxycodone to two

CVS pharmacies in Sanford, Florida to supply a population eight times the city's size.[ii] Cardinal Health has already paid $34 million in fines for a similar charge.[iii]

In 2012, McKesson paid $17.9 million in damages for distributing vials of anesthetic protocol to Nevada colonoscopy clinics. The vials were larger than was required, and their reuse was blamed for a 2008 hepatitis C outbreak.[iv]

Value Impact and Timing

Providing medical supplies or drugs that are deemed unsafe and are ultimately recalled can adversely impact revenues and potentially lead to increased liabilities through litigation.

Counterfeit Drugs

The World Health Organization estimates that the global market for counterfeit drugs has reached $431 billion, representing one percent of the U.S.'s supply chain, and 10–15 percent of the world's pharmaceuticals market. The issue presents a significant health and safety risk to consumers with an estimated 100,000 annual deaths attributed to substandard or counterfeit drugs worldwide. Health care distributors could face added costs, as the federal government, states, and federal agencies seek to implement pedigree tracking regulations in an effort to prevent counterfeit or mislabeled drugs from entering the pharmaceutical distribution system.

Evidence

In 2012, fake Avastin, a cancer medication, was distributed to pharmacies and doctors in the U.S. This incident articulates a growing problem in which 40 million prescriptions are filled with counterfeits in the U.S. each year.[v]

Concern over this issue has led to increased state and federal regulation. In 2010, the FDA released Serialized Numerical Identifier guidance for companies who serialize pharmaceutical packaging. California enacted a law that will go into effect in 2016, requiring chain of custody technology using radio frequency tagging and electronic pedigrees for the pharmaceutical distribution system.

AmerisourceBergen reports that "the increased costs of complying with these pedigree and other supply chain custody requirements could increase our costs or otherwise significantly affect our results of operations."

Value Impact and Timing

An influx of counterfeit drugs in the U.S. will present a negative impact on value as health care distributors will face costs associated with new strategies required to ensure product quality. In addition, companies in this industry may face reputation damages if they fail to detect counterfeit medications. As the market for pharmaceutical products continues to grow and the associated supply chain becomes more complex, counterfeit drugs are likely to present a long-term impact on profits and liabilities.

HUMAN CAPITAL

Health care distributors rely on human capital to maintain and create value. However, relative to other industries in the health care sector, these companies do not face specific and material risks or opportunities associated with human capital.

BUSINESS MODEL AND INNOVATION

As integral members of the health care supply chain, health care distributors need to address societal concerns through innovation. Specifically, companies in this industry will face increasing pressure to reduce packaging waste and encourage the proper disposal of pharmaceuticals through improved product lifecycle management.

Product Lifecycle Management

Health care distributors have a shared responsibility to reduce the environmental and health impacts of the products that they distribute. Specific opportunities to address these impacts exist in product packaging and take-back programs.

Evidence

In 2011, CVS Caremark announced that all of its 7,200 locations will offer Sharps Compliance Corp.'s Environmental Return System. This provides customers with the ability to dispose of their unused, expired, or unwanted drugs in a safe manner.[vi]

Cardinal Health developed guidelines to help health care providers and pharmacists host medication disposal days. In addition, the company partnered with the National Community Pharmacists Association and other organizations to support its Prescription Disposal Program.

Value Impact and Timing

Companies that are able to address the lifecycle of their products will be positioned to capitalize on growing consumer and supply chain demand, while alleviating the risks associated with developing regulations. Product lifecycle management has the potential to create shareholder value in the near and long term.

GOVERNANCE

Strict regulatory environments and competition in the health care distributors industry highlight the importance of strong governance. Management structures must be able to negotiate evolving policies while avoiding the risks associated with issues such as corruption and bribery. Information on governance performance is essential for shareholders to understand management quality and a company's ability to protect value.

Corruption and Bribery

Health care distributors, acting as wholesalers, have the power to negotiate with manufacturers, and subsequently play a critical role in pricing and product selection. Subsequently, companies in this industry are subject to various state, federal, and international laws including: the False Claims Act and the U.S. Foreign Corrupt Practices Act. The ability of companies to ensure compliance with relevant regulations is likely to have material implications.

Evidence

In 2012 Smith & Nephew PLC agreed to pay $5.4 million in disgorgement and prejudgment to settle a SEC charge of violation of the Foreign Corrupt Practices Act (FCPA) involving bribing of public doctors in Greece for more than a decade. The company's U.S. subsidiary agreed to pay a $16.8 million fine to settle parallel criminal charges by the U.S. Department of Justice.[vii]

In 2012 McKesson Corp. agreed to pay $151 million to 29 states and the District of Columbia to settle a lawsuit alleging the company inflated prices of hundreds of prescription drugs, causing state Medicaid programs to overpay millions of dollars in reimbursements.[viii]

In 2011, Cardinal Health paid $8 million for violations of the False Claims Act and Anti-Kickback Statute. The claims related to payments the company made to induce referral orders for its prescription drugs.[iv]

Value Impact and Timing

Companies that engage in unethical business practices are exposed to severe fines and litigation, adversely impacting profits and liabilities.

APPENDIX I: Top Five Companies by Revenue | Health Care Distributors

- McKesson Corp.
- Cardinal Health Inc.
- AmerisourceBergen Corp.
- Henry Schein Inc
- Owens & Minor Inc.

APPENDIX II: Evidence of Materiality | Health Care Distributors

The following table provides a summary of the evidence of materiality for each issue in the health care distributors industry.

MATERIAL SUSTAINABILITY ISSUES		EVIDENCE OF INTEREST					EVIDENCE OF FINANCIAL IMPACT				FORWARD-LOOKING IMPACT			
		MM	IWGs		Other	EI	Revenue / Cost	Asset/ Liability	Cost of Capital	EFI	Probability	Magnitude	Timing	FLI
			%	Priority										
ENVIRONMENTAL CAPITAL	Fuel Efficiency	30%	88%	3	•	Low	•			Low	•	•	Near	Yes
SOCIAL CAPITAL	Product Safety	70%	100%	1		High	•	•		Med				
	Counterfeit Drugs	70%	-	-	•	Med	•	•		Med	•	•	Near	Yes
BUSINESS MODEL AND INNOVATION	Product Lifecycle Management	35%	88%	4		Low	•			Low	•	•	Near	Yes
GOVERNANCE	Corruption and Bribery	85%	88%	2		High		•		High				

MM: Materiality Map, a percentile score of the relative importance of the issue among SASB's initial list of 43 generic sustainability issues. The score is based on the frequency of relevant keywords in documents (i.e., 10-Ks, shareholder resolutions, legal news, news articles, and corporate sustainability reports) that are available on the Bloomberg terminal for the industry's publicly listed companies.

IWGs: SASB Industry Working Groups

%: The percentage of IWG participants that found the issue to be material. (-) denotes that the issue was added after the IWG was convened.

Priority: Average ranking of the issue in terms of importance. One denotes the most material issue. (-) denotes that the issue was added after the IWG was convened.

Other: Other evidence of interest including: in-depth 10-k analysis, shareholder resolutions, corporate sustainability reports, traditional financial analysis, impending regulation, and academic studies. This is primarily used in cases where the issue was added after the IWG or the issue received lower MM and IWG scores. However, this test is also used in some cases where there is significant additional evidence of interest.

EI: Evidence of Interest, a subjective assessment based on quantitative and qualitative findings.

EFI: Evidence of Financial Impact, a subjective assessment based on quantitative and qualitative findings.

FLI: Forward Looking Impact, a subjective assessment on the presence of a material forward-looking impact

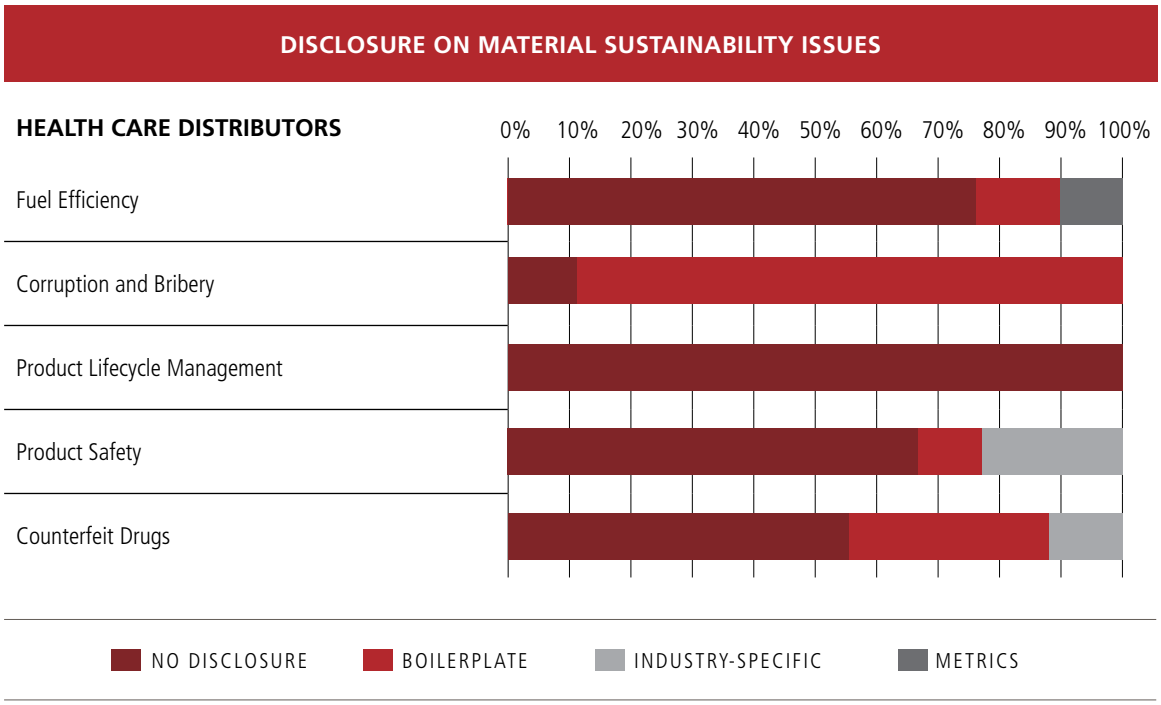
APPENDIX III: Sustainability Accounting Metrics | Health Care Distributors

The following table provides a list of sustainability issues and the associated accounting metrics for the health care distributors industry.

TOPIC	CODE	ACCOUNTING METRIC
Product Safety	HC0302-01	Description of legal and regulatory fines and settlements associated with product safety. Dollar amount of fines and settlements and a description of corrective actions implemented in response to events.
	HC0302-02	Description of efforts to minimize health and safety risks of products sold, including those related to toxicity/chemical safety (e.g., REACH substances of very high concern), high abuse potential (e.g., Schedule II controlled substances), or delivery (e.g., incorrect dispensing, mislabeling, transmission of disease through reuse of vials, etc.).
Counterfeit Drugs	HC0302-03	Description of methods and technologies used to maintain traceability of products throughout the distribution chain and prevent counterfeiting.
	HC0302-04	Description of due diligence process to qualify suppliers of drug products and medical equipment and devices.
	HC0302-05	Description of process for alerting customers and business partners of potential or known risks associated with counterfeit products.
Fuel Efficiency	HC0302-06	Payload fuel economy = gallons per ton-miles.
	HC0302-07	Description of involvement in efforts to reduce the environmental impact of logistics, including involvement in the EPA SmartWay program.
Product Lifecycle Management	HC0302-08	Description of initiatives to reduce the environmental impact of packaging, such as use of recycled materials, reductions in the amount of packaging material (i.e., dematerialization), and reduction in packaging waste (e.g., recycling and reuse of packaging, etc.).
	HC0302-09	Describe product stewardship initiatives to promote take-back (for reprocessing or recycling) of products tat the end of their lifecycle. Amount (by weight) of products accepted for take-back.
Corruption and Bribery	HC0302-10	Description of efforts to minimize conflicts of interest and unethical business practices, including mechanisms to ensure compliance.
	HC0302-11	Description of legal and regulatory fines and settlements associated with corruption or bribery, including Foreign Corrupt Practices Act and False Claims Act violations. Dollar amount of fines and settlements and a description of corrective actions implemented in response to events.

APPENDIX IV: Analysis of 10-K Disclosures | Health Care Distributors

The following graph demonstrates an aggregate assessment of how the top ten companies in the health care distributors industry are currently reporting on material sustainability issues in the Form 10-K.



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ISBN#: 978-1-940504-04-9

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